Executive Reporting On Internal Controls In Government

Prepared For The General Accounting Office
By A Task Force Of The Association Of
Government Accountants

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

December 8, 1980

The Accounting and Auditing Act of 1950 requires the heads of the executive agencies to establish and maintain effective internal accounting and administrative control systems. The same Act requires the General Accounting Office (GAO) to approve the agencies' accounting systems and GAO has regularly advised agencies that their systems will not be approved unless they have effective internal controls.

Interest in the need for strong internal control systems is exemplified by a recent bill, entitled the "Financial Integrity Act of 1980," which was proposed before the Congress. The bill, if passed, would require ongoing evaluations and reports on internal control systems of each executive agency. In an ongoing effort of support of effective internal control systems, the Association of Government Accountants (AGA) established a task force to help provide guidance and assistance to congressional committees and Federal agencies in developing standards and procedures for executive agencies to evaluate and report on their internal control systems.

This document entitled "Executive Reporting on Internal Controls in Government" was recently completed by the AGA task group. It provides a general discussion on the definition and objectives of internal accounting and administrative controls as well as suggesting reporting requirements that could be adopted whether or not the proposed legislation is passed. We in GAO believe this is an excellent document for bringing out further awareness for the need of strong internal controls, and we are certainly encouraged by the fine contribution of the task force of the Association of Government Accountants. We support the objectives of this document as well as the concepts and principles provided in it. This document is invaluable for informational purposes as well as a vehicle to encourage involvement in strengthening internal controls in Government.

We are providing it to you for your information.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

EXECUTIVE REPORTING ON INTERNAL CONTROLS IN GOVERNMENT

AGA TASK FORCE
ON FEDERAL EXECUTIVE REPORTING
ON INTERNAL CONTROL

Executive reporting on internal control has received great professional interest and has been the subject of heated discussions as to its pros and cons. Most of the controversy resulted from the Foreign Corrupt Practices Act of 1977 and the Securities and Exchange Commission's proposal to implement the Act with a requirement that certain companies provide a statement on the effectiveness of internal control systems with their annual reports. Further, certain Congressional committees became interested in proposing legislation that would require Federal executives to prepare annual reports on the adequacy of agency internal control.

In April, 1979, Arthur Schoenhaut, the National President, offered AGA's assistance to the U.S. Comptroller General in developing standards dealing with a Federal Executive report on Internal Control. In May, the Comptroller General accepted the offer, and the succeeding National President Frank Sato appointed a Task Force to propose such standards.

The Task Force's mission was not to debate or review the pros and cons of the executive reporting or the need for such legislation, but was to provide standards and procedures that can be followed if and when such legislation should be passed. For the past year the Task Force has worked seriously, diligently and enthusiastically to meet this mandate. We, the Task Force members, are proud and pleased to present this document in fulfilling our mission. It is our ardent hope and belief that this document will go a long way in advancing the state of the art in the very critical area of internal control. We are all pleased and honored to have been part of this effort.

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PRELUDE

More than 25 years prior to the enactment by the Congress of the Foreign Corrupt Practices Act (FCPA) mandating the maintenance of proper recordkeeping and internal accounting control systems in the private sector, a provision was included in the Budget and Accounting Procedures Act of 1950 requiring managements of all major Federal departments to implement and maintain effective systems of internal control in Government. Although there were undoubtedly many who took this charge seriously, the intervening period could be characterized as one in which movement toward the development of effective Government systems was undoubtedly slower than contemplated by the drafters of the legislation and often marked by the allocation of inadequate resources to the task. Certainly the length of time which has been consumed in the achievement of the General Accounting Office approval of agency accounting systems evidences a need for increased emphasis on the importance of accounting and control systems.

The importance of internal controls in the financial operations of an entity, be it public or private, has been dramatically demonstrated in Congressional testimony and other responses during and subsequent to the passage of FCPA legislation. In the late 70's the Goverment also experienced a rash of its own form of illegal, unauthorized, and questionable payments in the form of what has later been described as fraud, waste and abuse, thereby underlining the importance of the internal controls in Government. The seemingly unending disclosure of a broad range of scandalous examples of fraud, waste and abuse at all levels of government during a time when the public was initiating tax limiting legislation, such as "Proposition 13", has caused senior

Government officials to place increased emphasis on the importance and need to substantially improve internal controls in the Federal Government.

The Comptroller General of the United States has made numerous statements related to his concern with the inadequacies of internal controls in Government and has continuously reemphasized his early conviction that:

> "Our prime concern should be directed toward constructing systems of management control that will prevent fraud and abuse, make it more difficult, and decrease the likelihood of error and waste."

The executive and legislative branches of the Government have responded directly and effectively in their resolve to substantially improve Government's response to the widely-held opinion that internal controls, at all levels of Government, require dramatic and timely improvement. Evidence of their action has been demonstrated through the passage of Inspector General legislation in 1978, with a goal to increase emphasis on the prevention and detection of fraud, waste and abuse in Government. Also, the establishment by the Office of Management and Budget of its Financial Priorities Program in 1979 evidences their resolve to improving the accountability structure of all executive agencies. That program includes a number of initiatives to improve accounting practices and procedures and basic internal controls within agencies and departments.

The most recent action taken has been the introduction of the Financial Integrity Act of 1980 (Act) which has as its primary goal providing additional assurances that senior officials in Government view their responsibility for internal control systems

most seriously. The Act requires that identified system weaknesses receive Congressional and public disclosure until such time as effective action is taken to correct them. Accordingly, the legislation will necessitate the implementation of effective procedures within agencies and departments to assure the timely and continuous monitoring of the effectiveness of their internal control systems.

It is the purpose of this document to provide meaningful guidance to senior administrative officials of the Federal Government, by assisting them:

- o obtain a clear understanding of the scope and objectives of the legislation;
- o assess their personal responsibility for assuring their organization's compliance with the substance and form of the legislation;
- o identify the resources required to achieve compliance; and
- o understand how compliance may be achieved with the legislation through the performance of meaningful evaluations and effective reporting.

It is expected that providing administrative and program managers with a clearer understanding of the meaning and significance of internal control systems will foster the achievement of a higher level of coordination between them and financial managers in achieving compliance with the Act.

It is important to recognize that the material included herein deals principally in what factors to consider and how to organize a review to determine the effectiveness of control systems. It does not deal directly with the process of assessing whether individual controls are effective or ineffective--

necessary or unneccesary. The accounting profession, through its organizations and firms, has provided a wealth of information on how to evaluate the adequacy of individual controls surrounding activities or functions. However, insufficient information is currently available to senior executives and managers as to the factors to be considered and the organizational steps which should be taken to assure timely and accurate feed-back on the status and effectiveness of the internal control systems within their organizations. Further there is a need for improved understanding of the objectives of internal control systems.

It should be remembered, however, that even the most well designed systems of internal control have inherent limitations. They cannot provide absolute assurances that errors, omissions, or commissions of improper acts will not occur. Government programs which distribute funds or services through intermediary Governments or other organizations present additional risks and control limitations, since program control effectiveness will be dependent upon personnel and systems not totally under the control of the sponsoring Federal agency.

* * * * *

While the Congress and the Public hold Government in general accountable for the effectiveness of its systems of internal control, the establishment and maintenance of such systems has always been the specific responsibility of the heads of Federal departments and agencies. The guidance provided herein is intended to assist them in executing their responsibilities effectively.

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I

INTERNAL CONTROLS--A BASIC UNDERSTANDING

The Scope of the Control Review Contemplated by the Legislation

The Financial Integrity Act of 1980 specifies that the head of each executive agency designated by the Office of Management and Budget will be required to submit annually, to the President, a report on the adequacy of their agency's system of internal accounting and administrative controls. The Act requires a report on those controls which are designed to provide reasonable assurance that the following control objectives are achieved:

(1) All obligations and costs were in compliance with applicable law;

(2) All funds, property and other assets were safeguarded against waste, loss, unauthorized use or misappropriation; and

(3) All revenues and expenditures applicable to agency operations were properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

What Are Internal Controls

Probably the most difficult task in conveying an understanding of what is meant by the broad term Internal Controls is to agree upon a definition which is clearly understood by persons who have little or no background in the field of administration and financial management. The first question usually raised is; How do internal controls relate to accounting systems? Accordingly, one must first address the complementary relationship

between accounting systems and controls before attempting a more detailed understanding of factors affecting the quality of internal control systems.

Accounting systems, in a broad sense, include four principal components: (1) the system hardware, namely general ledgers and their inherent account structures, whether they be in the form of manually posted or machine processed records, (2) the assigned duties and responsibilities for maintenance of those records or the organizational structure adopted, (3) the specific procedures to be performed by persons in the execution of their role in the accounting process, the procedural controls, and (4) the information system or form of periodic reports which summarize incurred financial activity.

It is a fundamental premise of a sound accounting system that the organization of personnel and the specification of procedures to be performed should be constructed in such a fashion as to preclude any one individual from authorizing, approving and executing financial transactions. This is achieved through appropriate "segregation of duties" which results in the assignment of key control procedures to different persons or different organizational elements.

Internal Accounting Control has been defined by the American Institute of Certified Public Accountants as ". . . the plan of organization and the procedures and records that are concerned with safeguarding of assets and the reliability of financial records . . . ."

In addition to accounting related internal controls, every organization will implement a wide spectrum of additional controls usually referred to as Internal Administrative Controls.

Administrative Controls are designed to provide a structure to carry out other organizational objectives such as planning, productivity, programmatic quality, economy, efficiency, and effectiveness. In practice administrative controls and internal accounting controls have often been referred to by a number of alternative titles and terms. The significance of the title used is obviously of less importance than understanding the use and role of each such controls within the organization.

In its Standards for Audit of Governmental Organizations, Programs, Activities and Functions, the General Accounting Office included both accounting and administrative controls in its definition of internal control in Government. Internal Control is defined as:

> "The plan of organization and all the coordinate methods and measures adopted to safeguard assets, check the accuracy and reliability of accounting data, (accounting controls), promote operational efficiency, and encourage adherence to prescribed managerial policies (administrative controls)."

In performing a review of controls within a Governmental organization, it might be considered desirable to review each type (accounting and administrative) separately. However, in practice this is rarely, if ever, practical since managerial decisions in the administrative control area can often have a direct influence on the quality and adequacy of accounting controls. In a simple, but nonetheless effective example, the establishment within a unit of Government of administrative controls to foster and encourage a high level of supervision and review of employee performance can be expected to have a significant influence on the quality of employees' execution of accounting controls.

Accordingly, while the presence or absence of specific accounting controls can usually be readily determined, a review of the adequacy of the overall accounting control system will usually necessitate a review of administrative controls to the extent that they (1) establish an appropriate accounting control environment, (2) influence the nature of internal accounting control procedures required, or (3) help to satisfy internal accounting control objectives.

Administrative controls which can influence the control environment generally relate to those such as indicated in the example: (1) have an effect upon employees awareness of their responsibilities, (2) create a positive organizational attitude, (3) act as an incentive to employees to follow procedures, and (4) provide reasonable assurance that the failure to perform assigned procedures appropriately will result in disciplinary action.

Some administrative control procedures can also have a significant influence on the type of internal accounting controls required within the system. For example, an administrative decision which permits borrowers under loan programs to make payments at regional or district offices will necessitate a different series of accounting controls than those accompanying a system which permits loan repayments to be processed only through one centralized processing center.

Also, as pointed out, the implementation of certain administrative controls can strengthen or mitigate the need for accounting controls. The head of a department or agency may institute administrative procedures which delegate to program managers the responsibility to closely monitor and accept responsibility for financial, as well as programmatic activity. It is likely that

in the performance of their responsibilities program managers will, through their review and inquiry into the appropriateness of reported financial results, act as a monitor of the accounting system. In these circumstances program managers serve in the dual capacity of carrying out both a programmatic (administrative) and accounting control function.

In summary the term, Internal Controls, is broad and includes both accounting and administrative controls. Controls in either the administrative or accounting area are implemented through the segregation of key control duties and responsibilities among employees and the establishment of specific operating procedures which specify the manner in which their functions will be conducted. Accounting controls deal principally with safeguarding assets and the accuracy and reliability of accounting transactions and reporting. Administrative controls are typically designed to encourage adherence to prescribed managerial policies and promote operational efficiency.

While the control evaluation procedure discussed herein is <u>not</u> designed to evaluate administrative controls to assure efficiency and effectiveness, undoubtedly insights will be gained into these areas through this process. Further, it must be remembered that the adequacy of accounting controls can often be significantly influenced, positively or negatively, by administrative controls adopted by the organization.

As agreed by a wide spectrum of authors on the subject of control evaluation . . . an understanding of the distinction between accounting and administrative controls is useful for purposes of obtaining a fundamental knowledge of their interrelationship. However, the importance of the distinction becomes less significant if the attention of a control evaluation focuses

more appropriately upon the objectives which the organization is trying to achieve through the implementation of controls. While it might be contended by some that the objectives specified in the Act are more closely related to traditional accounting controls, that observation should not be viewed with significance. Rather, it should be the intention of department heads to assess the adequacy of both accounting and administrative control systems which are designed to achieve the previously listed broad objectives of the Act.

While the use of predetermined detailed checklists which identify customary or traditional control techniques can be of value, they should be utilized as a tool and not relied upon as the sole procedure for conducting control evaluations.

The Relationship Between Objectives and Controls

There is substantial agreement among professionals that an evaluation of a control system must begin with an identification of the organization's control objectives. It is assumed that management will convert broad control objectives (such as those in the Act) which relate to the organization as a whole, into specific control objectives for all affected organizational units and types of transactions. In most cases there will be a readily identifiable relationship between specified control objectives and the financial or operational risks against which protection is sought.

Some difference of opinion exists as to whether evaluations should be performed on a transactional or organizational (functional) basis; nevertheless, under either approach specification

of meaningful objectives is critical to the successful performance of a control evaluation. As an example, while the maintenance of adequate internal accounting controls is an appropriate overall objective for an executive department, effective determination of whether that overall objective is being achieved will necessitate the identification and review of numerous supporting objectives. Such a supporting payroll objective would be that--all employee overtime is approved prior to being paid. It would be expected that many supporting objectives of this nature would be expressed through policy statements or regulations.

As a further example, dissecting a small portion of one control objective specified in the legislation would identify the overall organizational objective that:

> "all . . . property . . . (is) safeguarded against . . . unauthorized use . . ."

In most agencies the achievement of that overall objective will frequently necessitate the identification of a significant number of supporting objectives relating to the often wide variety of property which is entrusted to the care of the agency and a specification of what, in each case, constitutes unauthorized use. It is expected that in many cases the necessity to identify control objectives will encourage management to address and establish positions on a number of issues which may not have been previously specified in either Federal regulations or previous agency policies. Many times opportunities for fraud, waste and abuse are created simply because inadequate attention is focused on defining control system objectives and organizational policy.

Once the objectives of a control system are identified, an effective evaluation to determine whether they are being achieved

can commence. The subsequent evaluation will focus upon whether or not objectives are being achieved, with little concern as to whether the controls relied upon are identified as either accounting or administrative controls.

To assist departments and agencies in the development of control objectives applicable to their own organizations, Chapter Two contains a discussion and description of the principal objectives usually related to frequently encountered functional areas in Government organizations.

ADP Considerations

Most systems involve the use of Automatic Data Processing equipment and systems. The reliability of an ADP system is dependent on the adequacy and the emphasis placed on controls during the development, installation, maintenance and use of the computer equipment and software. System specification and design control should be designed to ensure the development of effective and adequately controlled systems. Additionally, auditability of systems should be addressed throughout all aspects of their development.

How Should Evaluations Be Conducted

The unique attributes of each Government organization, program and administrative function do not lend themselves to delineating a single evaluation method. Likewise experience is lacking in conducting overall organizational control assessments within public as well as in the private sector. Considering these factors a model Action Plan to conduct internal control evaluations has been developed and is described in Chapter III of this guide. The plan is developed in six major steps from a

description of the head of the department's initial role, to the final independent review and opinion by management on the effectiveness of the department's or agency's control system.

The Action Plan described utilizes a Project Team approach. The intent of the plan is to systematically evaluate existing systems from those estimated to have the largest risk potential to those with the smallest risk or vulnerability. Since the control environment is subject to change, (i.e., personnel competency, integrity and sufficiency, along with program scope and objectives) higher risk areas will require reexamination on a more frequent basis.

Expected Results

In assessing whether the organization's control objectives are reasonably achieved the evaluators of the system will become principally involved in a review to determine whether (1) procedures adopted are appropriate in the circumstances, (2) key duties and responsibilities are properly segregated, and (3) policies and procedures are satisfactorily documented, communicated and executed.

Many contend that one of the most important aspects of any control system is how effectively individuals perform their functions. Consequently, in the performance of a control evaluation, the reviewers should be expected to arrive at a determination as to whether persons performing key functions appear to be executing their responsibility properly. They will also consider whether responsibilities are assigned to an appropriate level within the organizational structure. Evaluating whether key functions are properly assigned within the organization to individuals capable by training and experience to execute them

effectively, is of no less importance to the outcome of the evaluation than is judging the appropriateness of the procedures themselves.

II

IDENTIFYING CONTROL OBJECTIVES

INTRODUCTION

The previous Chapter included a discussion of the relationship between control objectives and control systems and procedures. It emphasized the importance of obtaining management agreement on the objectives of control systems prior to commencing a review to determine their adequacy.

It is highly unlikely that any two Government organizations will agree upon a single statement of control objectives. While certain similarities may exist, the control objectives of each agency would be expected to reflect the differing nature of their operations and constituencies, as well as management philosophies of the organization.

It should be stressed that in establishing overall departmental control objectives, the legislative as well as the procedural and specific control objectives, covered in this Chapter, should be considered. The detail level of control desired should be clearly defined based on a vulnerability analysis or other management decisions.

A number of the texts referred to in the bibliography recommend that the evaluations be performed on either a transaction basis (e.g., cash receipts, disbursements, etc.) or alternatively on a functional basis by system (e.g., payrolls, procurements, etc.). The selection of either basis appears to be largely a matter of personal preference. However, it should be emphasized that the common thread among all of the recommended procedures

is the requirement that objectives of the control system be clearly specified and agreed upon prior to implementation of the review process.

The logic of this approach seems clear. Certainly one must identify the desired end result before attempting to assess the effectiveness of its achievement. In addition, while the methods used to achieve certain objectives vary significantly based upon whether transactions are processed manually or using ADP systems, the objectives would nevertheless be expected to remain the same.

LEGISLATIVE OBJECTIVES

Financial Integrity Act (Act)

As mentioned earlier, the executive report required by the Act requires annual opinion by the head of an agency as to the adequacy of their agency's systems of internal controls. The Act states that for these purposes, the general objectives of a system of internal control are to provide reasonable assurances that:

- All obligations and costs were in compliance with applicable law;
- All funds, property, and other assets were safeguarded against waste, loss, unauthorized use or misappropriation; and
- All revenues and expenditures applicable to agency operations were properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets.

The Act provides further specificity to the previously mandated internal control responsibility of the heads of agencies established by the Budget and Accounting Act of 1950.

Budget and Accounting Act of 1950

The 1950 Act places responsibility for establishing and maintaining adequate systems of internal control upon the head of each executive agency. It also prescribes that accounting systems conform to the accounting principles, standards, and related requirements prescribed by the Comptroller General of the United States and that the systems be approved by him.

Accounting systems are considered an integral part of internal control systems. The 1950 Act defined the general objectives which each agency's accounting system should provide. These are:

- Full disclosure of the financial results of agency activities;
- Production of adequate financial information needed for agency management purposes;
- Effective control over the accountability for all funds, property, and other assets for which each agency is responsible;
- Reliable accounting results to serve as the basis for preparation and support of agency budget requests, for controlling the execution of the budgets, and for providing financial information required by the Office of Management and Budget;
- Suitable integration of agency accounting with the control accounting; and
- Reporting operations of the Treasury Department.

COMMON CONTROL TECHNIQUES AND SPECIFIC CONTROL OBJECTIVES

Assuring adequacy of controls and compliance to prescribed control procedures through an annual evaluation is necessary to provide an agency head with a basis for the required annual report to the President. The transaction systems or functions

usually found in Government organizations which will require evaluation are:

Overall Functions and Activities

--accounting and reporting
--automatic data processing

Payment Functions and Activities

--payroll
--contracts
--grants
--loans and loan guaranty
--pensions
--travel
--payables

Collection Functions and Activities

--accounts receivable
--collections

Other Functions and Activities

--cash and negotiable instruments
--letters of credit
--capital assets and material inventories

It should be recognized that even within the functional areas identified, it will usually be appropriate for agencies to specify control objectives to a subfunctional level. As an example, it would usually be practical to separately specify objectives in the contracts area to the sublevel of tangible property contracting and personal service contracts. Similarly it may be appropriate to further specify objectives in the grants area based upon the nature of recipients such as colleges and universities and other not-for-profit civic organizations. While there is no right or wrong answer as to the depth or level to which objectives should be specified, as a general rule, it is expected that

objectives be specified to the same level that controls are expected to be implemented.

The remainder of this chapter will be devoted to a discussion of (1) common control techniques applicable to all systems, followed by (2) an identification of specific control objectives associated with the previously identified transaction systems, functions or activities.

COMMON CONTROL TECHNIQUES

Documentation

If controls are expected to operate effectively it is essential that control procedures, policies, authorities and responsibilities be clearly and adequately documented. Once documented they should be available to personnel involved in their execution. Documentation usually takes the form of operations manuals and organization charts which describe and depict the role and responsibilities of all individuals engaged in the control system. Not only does proper documentation provide assurances that the method of, and responsibility for, following procedures is clearly communicated it is often a valuable tool in training new employees.

Segregation of Duties

A basic tenet of a sound internal control system is that no individual or small group of individuals should be in a position to control all aspects of a transaction. Responsibilities should be segregated and tasks should be structured to preclude them

from performing more than one "key" processing function or activity, such as authorizing, approving, certifying, accounting, and disbursing.

Supervision

Effective systems of internal accounting and administrative control require strict adherence to procedures and practices. Qualified and continuous supervision is necessary to assure agency management that desired procedures are being applied to safeguard the resources of the agency.

Security of Property and Records

The preservation and safekeeping of property and records of the Government is important to the prevention of their loss or misuse. Generally, procedures should include physical security of accounting records, negotiable instruments or securities, and other assets of the agency. Accordingly, procedures should be employed to ensure that appropriate recordkeeping and archival procedures exist and are followed.

Internal Audit

An internal audit or review function should be organized to continuously monitor policies, procedures, and practices related to all fiscal and accounting activities. Where appropriate reviews should include examining and testing of transactions. Also, procedures should exist to assure followup of audit findings and recommendations, and to assure timely corrective action by management.

Competency of Personnel

Personnel should be competent, by education, training and experience, to execute the control responsibility to which they are assigned. Unless personnel are technically qualified to execute the responsibilities of the positions they hold, agency heads cannot expect the effective execution of control policies, procedures and practices.

SPECIFIC CONTROL OBJECTIVES

The following represent control objectives associated with the previously identified transaction systems or functions which should be considered in performing a control evaluation. As previously noted these objectives must, of course, be tailored to the unique control requirements of each agency and its management.

Accounting and Reporting

a. Authorization and recordkeeping procedures provide proper, accurate, complete and timely accounting records and reports of assets, liabilities, commitments, obligations, receipts and revenues, expenditures, costs, and disbursements of the agency.

b. Financial reports provide necessary information in the format required by managers to assess performance and stewardship regarding financial viability, program activity, fiscal compliance and accountability.

c. Accounting systems are properly documented and changes to them are made in an adequately controlled environment so as to prevent unauthorized changes.

d. Accounting systems are maintained in accordance with approved designs and in accordance with legislative and executive branch policies and criteria.

e. Accounting systems are submitted for timely approval to the Comptroller General. Timely action is taken to identify and resolve matters preventing approval.

f. Administrative controls are submitted for timely approval by Office of Management and Budget. Timely action is taken to identify and resolve matters preventing approval.

g. Timely and periodic reconciliations are made to ensure that subsidiary records are in agreement with general ledger balances.

h. Timely and periodic reconciliations are made of agency cash account balances with those of the Department of the Treasury.

i. Timely and periodic comparisons of budget and actual expenditures are made and significant variances analyzed.

j. Temporarily undistributed expenditures are properly and timely distributed to proper accounts.

Automatic Data Processing

a. Systems provide for proper authorization of transaction input, adequate edit checks and necessary safeguard of sensitive input forms to insure accurate, proper, complete and timely entry of information.

b. Data are safeguarded to prevent unauthorized access, improper changes or loss.

c. Controls include: (1) appropriate operational logs to detect unauthorized use of the system; (2) operating instructions providing adequate information to operators on a "need to know" basis; (3) new programs and changes to existing programs are specifically authorized; and (4) appropriate change control procedures.

d. Systems produce intended outputs accurately, completely and timely.

Payroll

a. Appropriate authority is established and documented for the appointment, change, and termination of all personnel.

b. All compensation complies with current statutory or regulatory limitations.

c. Opportunities for duplicate or other improper payments are minimized.

d. Timely, accurate and complete attendance reporting is achieved.

Contracts

a. A reasonable number of responsible bidders are solicited for each significant procurement to insure adequate competition.

b. Objective evaluation of all bids and proposals, strict compliance with contract award procedures and consistently applied contract administrative controls.

c. Control over Government-furnished property and equipment is established to ensure that contractors are safeguarding, accounting, inventorying, preserving, maintaining, and reporting accurately the Government properties in their possession.

d. Prompt and appropriate contract close-out actions are taken.

Grants

a. Adequate description and availability of Federal assistance are publicized when appropriate. For entitlement grants, factors used in distribution formulas are accurately maintained.

b. Financial and compliance audits of grantee activity are performed at least once every two years.

c. Grantees' cost allocation plans are reviewed and overhead rates are negotiated periodically.

d. Grantees' procurement procedures are reviewed for compliance with regulations.

e. Grantees' program eligibility requirements are sufficiently detailed to ensure that the program beneficiaries are qualified to receive prescribed benefits.

f. Grantees implement sound organizational, budgetary and accounting systems that are periodically reviewed and evaluated.

g. Grantees assure that Government-financed property and equipment are properly accounted for, inventoried, safeguarded and maintained.

h. Prompt and appropriate grant close-out actions are taken.

Loans and Loan Guaranty

a. Applications for loans and loan guaranty are evaluated for appropriateness of eligibility, collateral, and other qualifying criteria prior to approval.

b. Title to property used as collateral is properly recorded, filed, and secured by a responsible custodian.

c. Periodic aged reports of loan balances due are prepared, reviewed and timely collection action taken.

d. Loan and loan guaranty repayments are collected, controlled and reported in a manner that is consistent with the applicable appropriation or other public law.

e. Periodic estimates are made of uncollectible loan balances. Such estimates are timely reported to management.

f. Proper write-off, conversion, and settlement or forgiveness of delinquent loans is assured.

Pensions

a. Files are maintained for each recipient containing evidence of eligibility and approval and computation of original and subsequent changes to payments.

b. Recipients are made aware of their personal responsibilities for continuance of payments.

c. Benefits paid to survivors or beneficiaries are subject to the same controls as other payments.

Travel

a. Proper controls are observed for issuing, recording, verifying, processing, reconciling, accounting, and reporting obligations, expenditures, and disbursements for travel and transportation.

b. The Standard Government Travel Regulations are implemented through appropriate administrative procedures which are updated as required.

Payables

a. All payables and other claims against the Government are promptly and accurately recorded.

b. Prepayment examinations and certifications of performance are made to ensure validity and clerical accuracy of claims prior to payment.

Accounts Receivable (other than loans or loan guaranty)

a. All receivables are recorded accurately and promptly.

b. Periodic reports of aged receivables are prepared, reviewed and timely collection action taken.

c. Separate accounts for major categories of receivables are maintained to facilitate clear and full disclosure of agency resources in its financial reports.

d. Periodic estimates are made of the portion of receivables that may not be collectible. Such estimates are separately reported on a periodic and timely basis.

e. Proper write-off, conversion, and settlement or forgiveness of receivables are assured.

Collections

a. Payments are made to a designated person other than the agency Claims or Program Officer. Claims are safeguarded while in the custody of the agency and are promptly transferred to the Treasury.

b. All collections are promptly and accurately recorded in the accounts.

c. Timely follow-up and collection are made of all amounts due to the Government and all procedures for effecting collection, including offset and installment payments, are utilized.

Cash and Negotiable Instruments

a. Physical security safeguards are maintained where cash and negotiable instruments are stored and processed.

b. The following items are protected from unauthorized use:

- Cash;
- Check signing machines;
- Signature dies;
- Blank checks, bonds, drafts and other securities;
- Partially prepared checks and bonds; and
- Mutilated or voided checks and bonds.

c. All receipts are properly recorded and deposited promptly.

Letters of Credit

a. Letters of credit are issued only to large dollar recipients who have a continuing relationship with the Federal Government and have an adequate cash management system.

b. Amounts available under letters of credit are constrained to assure they do not exceed available award authority; monthly limits on drawdowns are established based on cash flow needs.

c. Drawdowns from letters of credit are monitored to assure recipients do not draw in excess of current needs.

d. Expenditure reports are required and compared to program reports to assure funds are used for their intended purpose.

Capital Assets and Material Inventories

a. The distinction between a capital and operating expenditure is clearly identified for accounting purposes.

b. Only authorized and needed property is ordered.

c. All receipts of property are timely and accurately recorded in source documents and accounting records.

d. Detailed subsidiary records are maintained for individual capital assets and significant categories of material inventories; these are periodically reconciled to control accounts.

e. Periodic physical verification is made of the existence and condition of property and inventories.

f. Physical counts of property and inventories are reliable (i.e., accurate, complete and timely) and accounting records are adjusted accordingly.

g. Physical security measures are commensurate with the size, type, and value of property.

h. All issues, transfers, retirements, losses, and other variances are timely reported and accounted for.

III

ACHIEVING COMPLIANCE WITH THE FINANCIAL INTEGRITY ACT (ACT)

The Act (Appendix A) requires each department or agency head to express annually an opinion on the adequacy of their organization's system of internal controls. To comply with this requirement, each department or agency will need to develop an Action Plan to conduct continuous internal control evaluations which will form the basis for the annual opinion or report.

This Chapter discusses one systematic approach to organizing and performing a successful control evaluation. Appendix B provides a bibliography containing references to a number of other publications that outline alternative approaches.

The factors to consider in developing an Action Plan are described in six phases, as follows:

- Planning and Organizing the Evaluation Process;
- Establishing the Steering Committee;
- Formulating Key Evaluation Policies;
- Assigning Project Director Responsibilities;
- Reporting by the Project Teams; and
- Reporting by the Steering Committee.

The principal Action Plan participants and their overall roles are: (1) the head of a department or agency who must initiate the development of the Action Plan, give it policy direction, and be accountable for its results; (2) a Steering

Committee that is composed of senior members of the organization's major staff and operating components, converts the head of the department's or agency's broad policies into measurable goals, and provides policy guidance to Project Teams who are charged with performing the actual control evaluations; (3) Project Teams chosen from the organization's major operating components to perform control evaluations of assigned activities or functions; (4) a Project Team Director, who supervises the activities of the Project Teams in their performance of control evaluations; and (5) the Inspector General or Director of Audit who furnishes advisory assistance and separately reports on internal control matters as part of their normal surveillance process. A typical Control Evaluation Project is depicted in the accompanying flow chart in Figure 1.

PLANNING AND ORGANIZING THE EVALUATION PROCESS

Senior management officials should implement the intent of the Act through careful planning, close supervision, and continuing support. What is done and when, who is responsible, and what resources are to be applied to achieve control evaluation objectives are fundamental considerations. The Action Plan leading to the evaluation process should be important enough to be included in management's overall operating plans.

The Action Plan may provide for multi-year execution, since all significant functions and activities may not require or be able to be evaluated annually. Additionally, since programs and activities are subject to change or restructuring, the Action Plan should be sufficiently flexible so as to be able to accommodate changed circumstances by allowing adjustments to the evaluation process.

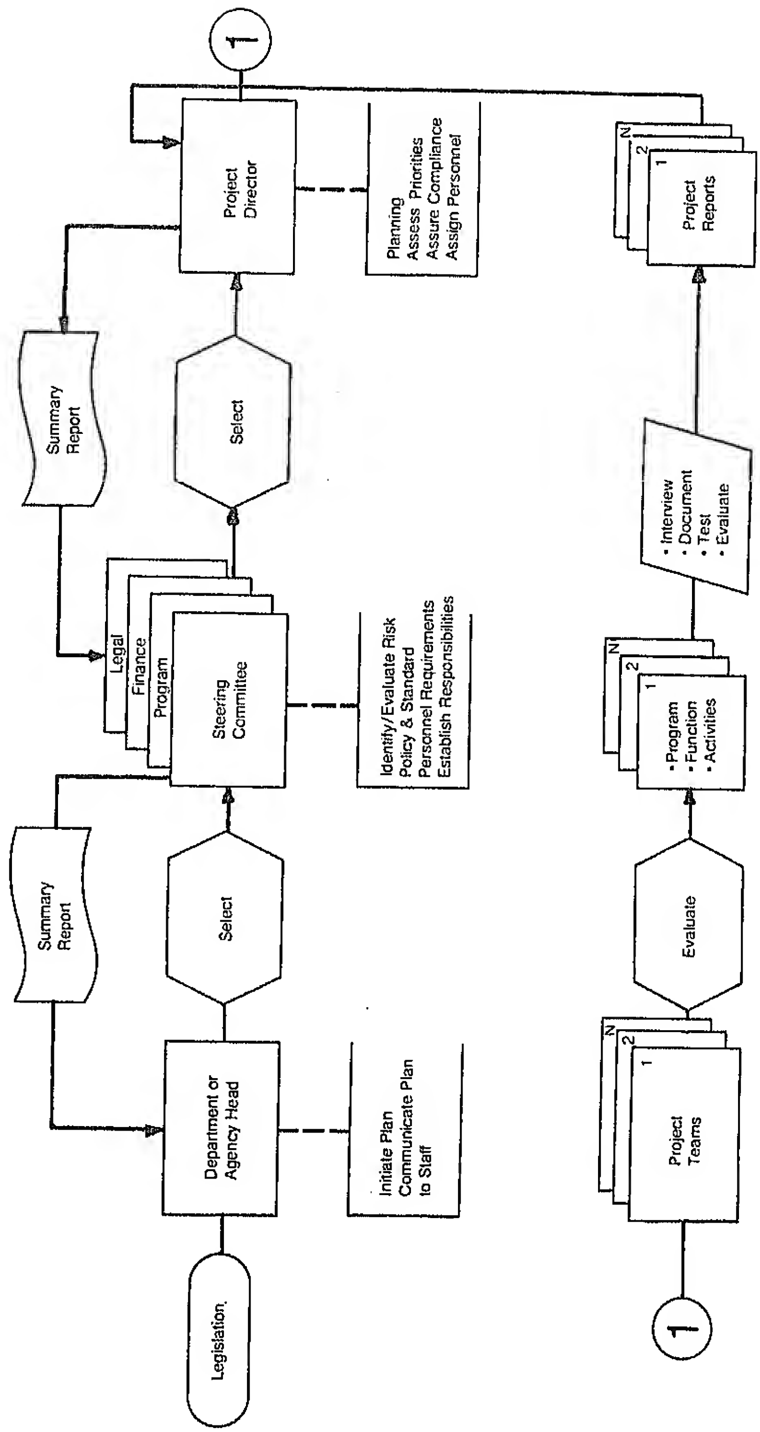
Legislation
Department or Agency Head
Initiate Plan
Communicate Plan to Staff
Summary Report
Select
Steering Committee
Legal
Finance
Program
Identify/Evaluate Risk
Policy & Standard
Personnel Requirements
Establish Responsibilities
Summary Report
Select
Project Director
Planning
Assess Priorities
Assure Compliance
Assign Personnel
1
1
Project Teams
1
2
N
Evaluate
• Program
• Function
• Activities
1
2
N
• Interview
• Document
• Test
• Evaluate
Project Reports
1
2
N

Figure 1

The authority to conduct a control evaluation should be delegated from the agency head to a Steering Committee charged with the responsibility to prepare the Action Plan and oversee the conduct of detail control evaluations. To establish the proper environment for conducting the evaluation, the department or agency head should communicate to all principal staff members of the organization the intent and key provisions of the Action Plan and the Steering Committee's responsibility and role.

ESTABLISHING THE STEERING COMMITTEE

The primary role of the Steering Committee is to formulate broad policies, monitor the progress of the evaluation, review the results of Project Team evaluation efforts, and formulate overall conclusions on control effectiveness. Ultimately, the product of its efforts will serve as the basis for the department or agency head's annual opinion on internal controls expressed to the President, the Congress and the Public.

The Steering Committee's role is most crucial to the performance of a successful evaluation. The policies it formulates will affect the quality and completeness of the control evaluation. Therefore, it is essential that competent and dedicated members be selected to serve on the Steering Committee.

Factors to be considered in selecting Committee members are knowledge and experience in such areas as:

1. Program areas, particularly those which are large, complex, and/or perceived as risky;
2. Legal, legislative, and regulatory matters;
3. Financial and administrative operations;
4. Procurement of goods and services;

5. Internal review, audit, or Inspector General activities; and

6. Automatic data processing.

Membership should be sufficiently broad to ensure the formulation of balanced policies and procedures, and the objective assessment of control evaluation results. Opportunity for objective assessments is enhanced if the agency head makes it clear that the Steering Committee members have a responsibility to the entire organization and not the organizational units to which they are permanently assigned.

FORMULATING KEY EVALUATION POLICIES

The Steering Committee will formulate key evaluation policies in the following areas:

1. Identifying and Evaluating Control Risk. One of the first undertakings of the Steering Committee should be to characterize and identify the types of control risks that are inherent in the department's or agency's operations. Risk and vulnerability must be carefully assessed before it can be determined which organizational programs, functions or activities should be evaluated and in what sequence or priority.

Organizations face both external and internal control risks. The former relates to forces outside of the organization such as catastrophes, legislation, court decisions, societal reactions and standards. Internal risk is an organization's exposure to loss attributable to acts of its own officials and employees either by their intentional or unintentional failure to adhere to the organization's established practices and procedures and acceptable ethical conduct.

The Steering Committee should establish management's defined level of acceptable risk. That is the point beyond which management is not willing to (1) tolerate loss of assets and revenues; (2) accept a margin of error in reports and information; (3) permit illegal or unethical acts; and (4) sustain adverse public opinion.

Identifying the acceptable level of risk within elements of the organization will be a key factor in determining the activities to be evaluated and the extent or scope of the review to be conducted.

The Vulnerability Assessment Grid in Figure 2 is one example of how program function or activity risk can be assessed and documented. The Grid consists of four designated levels or quartiles of control vulnerability--High, Limited, Moderate, and Little. Those factors which are considered to impact vulnerability are listed in each level, modified by a qualitative description appropriate to each level of vulnerability. Each factor is graded for the activity or function being evaluated by identifying the quartile description which most clearly characterizes that aspect of the function or activity. Finally, the Risk Point Value assigned to each factor is totaled and compared to other activities to establish relative vulnerability. The levels of vulnerability, designed factors, and grading system can be altered to suit the judgments of each department or agency Steering Committee.

2. Establish Policies and Standards. The Steering Committee should formulate policies or standards which will guide Project Team performance. At a minimum, these policies should encompass:

Figure 2

Vulnerability Assessment Grid

VULNERABILITY FACTORS	RISK VALUE
Highly Controlled — Little Vulnerability	1
- Precise Legislative Authority - Minimal Budget Authority/Outlays - Complete Government Program Administration - Ample Administrative Resources Provided - No Commercial Value - Minimal Public Involvement - Extensive Written Procedures - Timely and Adequate Financial Reporting	
Little Control — Limited Vulnerability	3
- Unspecific Legislative Authority - Limited Budget Authority/Outlays - Mostly Third Party Program Administration - Minimal Administrative Resources Provided - Limited Commercial Value - Selective Public Involvement - Partially Effective Written Procedures - Financial Report Not Comprehensive	

VULNERABILITY FACTORS	RISK VALUE
Moderately Controlled — Moderate Vulnerability	2
- Broad Legislative Authority - Moderate Budget Authority/Outlays - Joint Third Party & Government Program Admin. - Adequate Administrative Resources Provided - Substantial Commercial Value - Moderate Public Involvement - Essential Areas Have Written Procedures - Financial Reports Adequate But Not Timely	
No Control — High Vulnerability	4
- Vague Legislative Authority - Large Budget Authority/Outlays - All Third Party Program Administration - No Administrative Resources Provided - High Commercial Value - Widespread Public Involvement - No Written Procedures - Late and Incomplete Financial Reporting	

a. Working paper documentation standards to be used in conducting evaluations.

b. Performance standards and guidelines including the appropriate use of testing techniques such as statistical sampling, simulation and modeling, processing of fictitious transactions, etc.

c. The appropriate use of the reports of independent third parties on internal control and related matters.

d. Materiality guidance for purposes of establishing reportable control weaknesses.

e. Guidelines for the reporting of weaknesses to line management and subsequent follow-up to assure timely corrective action.

3. Defining Personnel Requirements. Project success will greatly depend upon the quantity and quality of staff resources available to perform the evaluation. One of the Steering Committee's principal responsibilities should be to establish preliminary time goals for the completion of the evaluation and the identification of staff resources needed to support the Action Plan. The Committee should also be responsible for securing a management commitment to provide the required manpower resources neceessary to meet established time goals.

To supplement assigned Project Team personnel, operating management of the program functions or activities being evaluated can be invited to participate in the conduct of evaluations.

The principal reasons for incorporating operating management representatives in the evaluation process is to: (1) add increased insights and perspectives into the areas being evaluated; (2) strengthen managerial commitment to the project; and (3) promote acceptance of the evaluation results and timely correction of weaknesses.

The Committee should also address those circumstances in which it is considered appropriate to use outside consultants or experts in such areas as ADP, engineering, financial, legal, personnel, insurance, procurement, statistics, and economics.

Closely related to resource policy issues is the appropriate use of internal audit or Inspector General staff. In most circumstances kthey should be limited to an advisory role.

4. Documenting and Communicating Responsibilities. To achieve a successful, complete, orderly, and timely evaluation, the roles and responsibilities of each participant must be clearly stated and understood. This includes those of the Steering Committee, Project Teams, the Project Team Director and other participants. Their authorities and responsibilities should be formally documented. In addition, the goals and objectives of the Action Plan should be formalized in writing, approved by the agency or department head, and communicated throughout the organization. Line management support for the control evaluation effort is critical to achieving success and is predicated largely on their understanding of its goals and objectives. Further, program and administrative elements of the organization will be asked to cooperate with Project Team efforts and contribute staff resources to the evaluation. Their clear understanding of management support for the project will provide assurances of their continuing support and cooperation.

ASSIGNING PROJECT DIRECTOR RESPONSIBILITIES

Planning, executing, evaluating and preparing timely reports on a series of diverse internal control evaluations requires significant organization.

Project Teams should be formed under the direct supervision of a Project Team Director to conduct the individual program or activity evaluations specified by the Steering Committee. The Project Team Director will be the focal point for: (1) planning assigned evaluation projects; (2) assigning project priorities, as well as specific evaluation tasks; (3) assuring compliance with standards and guidelines established by the Steering Committee; (4) arranging for manpower and logistical support; (5) acting as the senior spokesperson in dealing with management of the functions or activities being reviewed; (6) evaluating Project Team results; and (7) preparing reports to the Steering Committee.

It is likely that several different functions or activities will be reviewed simultaneously by different Project Teams. Accordingly, to assure that project staff is used effectively, sound project management techniques should be used. Project phases should be defined with fixed time goals and required interim progress reports. Milestone charts, baseline planning schedules, and PERT charts for large complex reviews are useful tools in monitoring activities of this nature.

REPORTING BY THE PROJECT TEAMS

At the conclusion of a Project Team's evaluation of internal controls within an assigned function or activity, it will prepare a report summarizing the results of its findings. The report is

expected to summarize major control weaknesses identified and the reaction of operating management to the issues and recommendations presented. It would also be appropriate to comment in the report on the extent to which other compensating or alternative controls could be relied upon to mitigate any weaknesses identified.

The report should suggest the extent of efforts and resources estimated to be involved in correcting reported weaknesses, an estimate of the cost benefit relationship of recommended control enhancements, a suggested time frame for implementation of recommendations, and the extent and degree of cooperation received in conducting the review. The responsiveness of management of the function being evaluated to weaknesses reported in a previous evaluation or by other evaluators, such as the Inspector General, should also be included.

The Project Team Director will review each report and its conclusions with the Project Team and management of the affected activity. This may be accomplished through participation in the Project Team's exit conference. The Project Director will add to the report any clarifying or amplifying information deemed appropriate and schedule the report for review by the Steering Committee.

REPORTING BY THE STEERING COMMITTEE

Although not limited in its communications, the Steering Committee must of necessity submit at least one report annually to the head of the department or agency. This report, together with the results of personal discussions with the Steering Committee, will usually form the primary basis for the agency or department head's report to the President. Accordingly, the

annual Steering Committee report must include: (1) an identification of the reviews conducted during the year; (2) a summary of the results of those reviews; (3) the Steering Committee's recommended action, where management disagrees with the necessity for recommended control improvements; and (4) an estimate of resources needed to effect improvements and associated cost benefit considerations. Most importantly the Steering Committee will recommend the nature and form of report to be issued to the President by the head of the agency. Further discussion of the content of such a report is included in the following chapter.

IV

REPORTING

The Annual Report of the Chief Executive of Departments or Agencies

The Act requires the head of each executive agency designated by the Office of Management and Budget, beginning in 1981, to prepare an annual report on the adequacy of the agency's systems of internal accounting and administrative control. The report must be submitted to the President and shall also be available to the Congress and the Public.

The purpose of the report is to provide the Congress and central policy agencies with an awareness of the adequacy of control systems in departments and agencies throughout the Federal Government. Internal accounting and administrative control systems have always been the primary responsibility of management and they have been the subject of auditors' reviews. However, the passage of the Act demonstrates the increasing concern of the Congress and the Public with maintaining an awareness of the status of control systems and their conviction that effective control systems contribute to better Government.

It is expected that the reporting requirement will direct increased management attention to the importance of controls. Managements will henceforth be required to assess their agency's internal control systems by making a critical evaluation of their adequacy before preparing required annual reports.

Suggested Content of Agency Reports on Controls

Under the Act, the Director of the Office of Management and Budget (OMB), in consultation with the Comptroller General, is required to establish the exact form of reporting to be used by agency executives and provide a general framework to guide them in performing evaluations of systems of internal accounting and administrative control. However, it is expected that a significant degree of reporting discretion shall be permitted, in which case consideration should be given to the following matters.

The Act states that an adequate system of internal accounting and administrative control should provide reasonable, not absolute, assurance that the following objectives are achieved:

- All obligations and costs were in compliance with applicable laws;
- All funds, property, and other assets were safeguarded against waste, loss, unauthorized use, or misappropriation; and
- All revenues and expenditures applicable to agency operations were properly recorded and accounted for to permit the preparation of reliable financial and statistical reports and to maintain accountability over assets.

Management's report on its systems of internal control should, therefore, address whether in their opinion the systems appear to provide reasonable assurance that these objectives were achieved during each fiscal year. In this regard the report should include management's acceptance of primary responsibility for the adequacy of internal accounting and administrative controls.

If no material weakness has been identified by management during its ongoing evaluation of controls, an unqualified opinion concluding that systems provide reasonable assurance of achieving control objectives specified by the Act can be expressed by management. If, however, a review discloses material control system weaknesses which indicate all control objectives may not be completely achieved, management would be precluded from expressing an unqualified opinion. The report should in these circumstances identify the material weaknesses which prevent the systems from completely achieving their objectives and describe management's plans for correcting these weaknesses.

Management should include in its report any explanation on unresolved findings on internal controls disclosed in internal or external audit reports. Such disclosures should describe the corrective action being taken or contemplated with target dates concerning uncorrected material weaknesses identified in the audit reports.

Management may also describe the extent of efforts it has undertaken to comply with the Act. Such description, for example, may include a discussion of the plans adopted to perform ongoing evaluations of internal accounting and administrative controls and the progress made in completing their implementation.

In addition, management's report should include a description of the status of GAO approval of its accounting system design and, where appropriate, plans for achieving approval status. It should be recognized, however, that GAO's review and approval of executive agency accounting system designs involves an initial evaluation of internal accounting controls which will

require periodic reevaluations by the agencies after implementation.

Consideration should also be given to describing the status of OMB approval of administrative controls and fund procedures.

Inspector General or Internal Auditor Reporting

Inspectors General, as part of their currently required semiannual reports to the Congress, are expected to summarize any findings, opinions, conclusions or recommendations they may have regarding the internal accounting and administrative controls of their agency. For those agencies without an Inspector General, the head of the internal audit department should be expected to prepare a similar report to the head of their department or agency. In addition, Inspectors General and Internal Auditors are required by the Act to receive, investigate and report any allegations that agency employees have provided false or misleading information in connnection with the agency's evaluation of its control systems. The reporting responsibilities of the Inspector General and agency head are expected to be complementary, not redundant.

Director of OMB Reporting

After receipt of the Executive reports from departments and agencies the Director of OMB is expected to summarize their contents. This summarization will provide an overview of the control environment in the Federal Government as a whole and is expected to provide the President and the Congress with a plan and timetable for correcting any reported material weaknesses of the control systems in the Government.

V

OTHER EVALUATION CONSIDERATIONS

The Importance of the Control Environment

In the earlier discussion of controls, it was pointed out that administrative controls are largely responsible for establishing the control environment or control consciousness of an organization. In the discussion of the types of administrative controls which are responsible for creating the control environment, it was pointed out that generally they are the types of controls which (1) influence the degree of employee awareness of their individual responsibilities, (2) their impression of management's attitude toward maintaining an appropriately controlled environment, and (3) their perceptions of the discipline which exists within the organization. In short, their perception of whether failure to comply with controls will result in appropriately measured disciplinary action.

It is widely accepted that the most influencing factor on the credibility of an organization's control system, be it either accounting or administrative, is the state of its control environment. It is a frequent impression that Government often fails to create an appropriate control environment within its organizational units that has led to fraud, waste and abuse. Because of the importance ascribed to this area by both professionals and the Public, additional comments appear particularly warranted.

A special advisory committee on internal accounting control organized by the American Institute of Certified Public Accountants concluded that "an overall evaluation of an organization's internal accounting control environment is a necessary prelude

to the evaluation of control procedures and techniques." The committee stated further that:

> ". . . a poor control environment would make some accounting controls inoperative for all intents and purposes; for example, individuals would hesitate to challenge a management's override of a specific control procedure. On the other hand, a strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific accounting control procedures and techniques."

The committee identified a number of factors which they believed to be important to the development of appropriate attitude, awareness, and discipline within an organization. They included:

- Organizational Structure--the establishment of appropriate reporting relationships, identification of functions to be performed by organizational units, and the establishment of authority, responsibilities, and constraints of key positions;

- Personnel--the competence and integrity of the organization's personnel;

- Delegation of Authority and Communication of Responsibility--appropriate delegation or limitation of authority in a manner that provides assurance that responsibilities are effectively discharged;

- Budgets and Financial Reports--formulation and communication of organizational goals through appropriate levels of budgeting and financial reporting;

- Organizational Checks and Balances--the establishment of an appropriate level of financial control and internal auditing; and

- ADP Consideration--when utilized, an awareness of the strengths and exposures inherent in such an installation and the implementation of controls to give recognition to their existence.

While the importance of these individual areas cannot be disputed, it remains that the single most determinate factor surrounding the implementation and maintenance of an adequate control system is the "attitude" of senior management of the department or agency toward the importance of controls. Attitudes will not only affect the quality of employee performance, but also the quality of accounting, EDP and reporting systems, all of which dramatically influence organizational and programmatic effectiveness. If management demonstrates a lack of interest in development and maintenance of an appropriate control environment or contributes to its deterioration through indifference, a control system will quickly deteriorate into ineffectiveness. This is also the likely result if management does not implement an appropriate control monitoring procedure through the use of an effective internal audit process, periodic management review, or an appropriate combination thereof.

The importance of the monitoring process cannot be overemphasized. It must be remembered that most control systems are not self-correcting. If control failures occur and no monitoring process is in place to detect their occurrence, the failure might be disclosed only by the detection of a subsequent fraud. Further, the activities of large government departments are dynamic. A control system to be effective must be responsive to changing conditions. And lastly, control systems are heavily dependent upon effectiveness of people and their basic competence and honesty, their adequacy in number and their supervision. The frequent high rate of change of job assignments in Government places special emphasis on the necessity for an effective and continuous monitoring process as a check on the maintenance of a high level of control compliance and execution.

Organizational Responsibilities

It is a frequent misconception in the Government that controls are the exclusive domain of the accounting or finance areas of the organization. Or even more disconcerting, that programmatic objectives and controls and accounting controls should be evaluated on a mutually exclusive basis. Effective execution of accounting and reporting activities requires the coordination and cooperation of all segments of the organization, be they administrative, programmatic or financial. The quality of the control environment and the control system, and the public's perception of the level of accountability achieved by the organization are totally dependent upon the coordination of administrative, programmatic and financial personnel.

Symptoms of Control Deficiencies

Experience has indicated that the existence of one or more of the following danger signals will usually be indicative of a poorly maintained or vulnerable control system. These symptoms may apply to the organization as a whole or to individual departments or activities. Newly appointed chief executives usually place a high priority upon a personal evaluation of these areas, because they usually dictate the quality of operational, as well as financial, control exercised by the organization. These danger signals include:

- A clear statement does not exist for standards of employee ethical conduct;
- Policy and procedural or operational manuals are either nonexistant or are not currently maintained;
- Lines of organizational authority and responsibility are not clearly articulated or are nonexistent;

- o Financial and operational reporting is not timely and is not utilized as an effective management tool;
- o Line supervisors ignore or do not adequately monitor control compliance;
- o No procedures are established to assure that controls in all areas of operation are evaluated on a reasonable and timely basis;
- o Internal control weaknesses detected are not acted upon in a timely fashion; and
- o Controls and/or control evaluations bear little relationship to organizational exposure to risk of loss of resources.

Care should be exercised by all organizations to assure that these symptoms or danger signals, if present within the organization, are not permitted to continue unabated.

A number of efforts are taking place within the Public and Private Sectors to identify other symptomatic areas of weakness usually associated with inadequate control systems. The AICPA's Standing Committee on Methods, Perpetration and Detection of Fraud as well as others[1] have identified and published lists of conditions which often signal fraud opportunities. One of the primary objectives of the Task Force on Prevention of Fraud, Waste and Abuse in Government, organized by the Comptroller General of the United States, has been to study, classify and publish information dealing with those organizational or control factors which have contributed to previously disclosed acts of fraud, waste and abuse in the Government. These sources can provide valuable input to persons organizing and conducting control reviews.

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1. Management Accounting, Red Flagging the White Collar Crime Wave, 1980, Marshall B. Romney, W. Steve Albrecht and David J. Cherrington.

Limitations Inherent in Control Systems

Insofar as accounting control systems are concerned, the accounting profession has always recognized that, at best, systems can only be expected to provide reasonable assurance that their objectives are achieved. Consequently, no system should be implemented without giving effect to cost/benefit considerations. Whether it be in the initial development of a control system or consideration of system enhancements, controls should not be implemented unless a reasonable cost/benefit relationship can be established. Of course, it should be recognized that not all factors bearing on cost/benefit decisions can be reduced to monetary terms and, accordingly, certain decisions will entail the use of considerable subjective judgment.

The American Institute of Certified Public Accountants has identified four other limitations of any system of internal accounting control. These limitations are generally stated in the following terms:

- In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors;
- Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion;
- Control procedures with respect to the execution and recording of transactions may be ineffective against either errors or irregularities perpetrated by management or inappropriate estimates and judgments by management in the preparation of financial statements; and

> Projection of the adequacy of current internal accounting controls to future periods is subject to the risk that controls may become inadequate due to changes in conditions or due to the fact that compliance with control procedures may deteriorate.

It should be remembered that no system of internal control is perfect and the need for controls is ever changing. Factors such as cost/benefit, reasonable assurance, and the other practical limitations inherent in control systems require managements and the reviewers of control systems to maintain a constant awareness of system limitations as well as organizational vulnerability and risk. Additionally, reviews of control systems should not only focus on apparent weaknesses but should also give attention to instances of control excesses. The need in the Government is not necessarily for more controls, but better controls.

APPENDIX A

FINANCIAL INTEGRITY ACT

A BILL

To amend the Accounting and Auditing Act of 1950 to require ongoing evaluations and reports on the adequacy of the systems of internal accounting and administrative control of each executive agency.

Section 1. Short Title.

This Act may be cited as the FINANCIAL INTEGRITY ACT of 1980.

Section 2. (a) Findings.

The Congress hereby finds that:

(1) Fraud, waste, and mismanagement have caused a serious crisis of confidence in Federal government programs and agencies.

(2) Fraud and errors in Federal programs are more likely to occur from a lack of effective systems of internal accounting and administrative control in the Federal agencies.

(3) Effective systems of internal accounting and administrative control provide the basic foundation upon which a structure of public accountability must be built.

(4) Effective systems of internal accounting and administrative control are necessary to provide assurance that Federal assets and funds are adequately safeguarded as well as to produce reliable financial information for the agency.

(5) Systems of internal accounting and administrative control are necessarily dynamic and must be continuously evaluated and where necessary improved.

(6) Reports regarding the adequacy of the systems of internal accounting and administrative control of each Federal agency are necessary to enable the Executive Branch, the Congress and the public to evaluate the agency's performance of its public responsibilities and accountability.

(b) Policy.

It is hereby declared to be the policy of the United States that:

(1) Each Federal agency must maintain effective systems of internal accounting and administrative control as an integral part of its management practices.

(2) The systems of internal accounting and administrative control of each Federal agency shall be evaluated on an ongoing basis and when detected, weaknesses must be promptly corrected.

(3) All levels of management of the Federal agencies must involve themselves in assessing and strengthening the systems of internal accounting and administrative control to minimize fraud, errors, abuse, and waste of government funds.

Section 3. As used in this Act:

(a) The term "President" means the President of the United States.

(b) The term "Comptroller General" means the Comptroller General of the United States.

(c) The term "Director" means the Director of the Office of Management and Budget.

Section 4.

Section 113 of the Accounting and Auditing Act of 1950, as amended (31 U.S.C. §66a), is amended by adding at the end thereof the following new subsection:

(d) (1) To ensure that the requirements of subsection (a) (3) of this section are fully complied with, the head of each executive agency which the Director determines to be covered by this subsection, shall prepare a report stating an opinion on the adequacy of the agency's systems of internal accounting and administrative control by December 31, 1981, and by December 31 following the end of each fiscal year thereafter.

(2) The reports shall be signed by the head of each executive agency and addressed to the President. Such reports shall also be made available to Congress and the public.

(3) By December 31, 1980, the Comptroller General in consultation with the Director shall establish a system of reporting and a general framework to guide the agencies in performing evaluations on their systems of internal accounting and administrative control. The Comptroller General, in consultation with the Director, may modify the format for the report or the framework for conducting the evaluations from time to time as deemed necessary.

(4) Internal accounting and administrative controls are to be defined by the Comptroller General, and shall provide reasonable assurances that:

(i) All obligations and costs were in compliance with applicable law.

(ii) All funds, property, and other assets were safeguarded against waste, loss, unauthorized use or misappropriation.

(iii) All revenues and expenditures applicable to agency operations were properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical

reports and to maintain accountability over the assets.

Any inadequacy or material weaknesses in an agency's systems of internal accounting and administrative control which prevents the head of the agency from stating that the agency's systems of internal accounting and administrative control provided reasonable assurances that each of the objectives specified above were achieved shall be identified and the plans and schedule for correcting any such inadequacy described in detail.

(5) (a) The Inspector General of an executive agency or, if no Inspector General exists for an agency, the head of the internal audit staff, shall receive and investigate any allegation that an employee of the agency provided false or misleading information in connection with the evaluation of the agency's systems of internal accounting and administrative control or in connection with the preparation of the annual report on the systems of internal accounting and administrative control.

(b) If, in connection with any investigation under subparagraph (a), the Inspector General or the head of the internal audit staff, as appropriate, determines that there is reasonable cause to believe that false or misleading information was provided, he shall report that determination to the head of the agency.

(c) The head of the agency shall review any matter referred to him under subparagraph (b) and shall take action under Chapter 75 of Title 5, United States Code, or such other disciplinary or corrective action as he deems necesssary.

APPENDIX B

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☆ U.S. GOVERNMENT PRINTING OFFICE: 1981 — 720-023/4822 REGION 3-1